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The economic outlook

Melbourne

[1930]

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Sir
Copland, Douglas Berry, 1894-
The economic outlook ... Melbourne, Published by the proprietors of "The Argus" and "The Australasian" [1930]
8 p. 23 cm.

Caption-title: "by Professor D. B. Copland."
"Reprint of a series of articles which appeared in "The Argus," Melbourne, on June 19, 20, and 21, 1930."

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TECHNICAL MICROFORM DATA

FILM SIZE: 35mm REDUCTION RATIO: 11:1 IMAGE PLACEMENT: IA (IIA) IB IIB

DATE FILMED: 5-8-97 INITIALS: PB

TRACKING # : MSH 24115

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THE ECONOMIC OUTLOOK

Reprint of a series of articles which appeared in "The Argus," Melbourne, on June 19, 20, and 21, 1930.

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PUBLISHED BY
THE PROPRIETORS OF
"The Argus" and "The Australasian"
Melbourne
FOR GRATUITOUS DISTRIBUTION.

These articles appeared in "The Argus," Melbourne, of June 19, 20, and 21, 1930.

The Economic Outlook

CORRECTING THE DEFICIENCY

Palliatives and True Remedies

Internal Costs the Basic Problem

By PROFESSOR D. B. COPLAND.

I.

During the last six months financial policy in Australia has been directed toward correcting a deficiency in the balance of payments, and in particular to meeting heavy overseas interest payments. The causes of the deficiency in the balance of payments need no elaboration. They are three in number—a sudden cessation of long-period borrowing overseas, a serious decline in the price of wool, and a shortage in exports of wheat. An exact statistical measure of the balance of payments is not possible, but some idea of the magnitude of the decline in the credit items may be given. The total exports of the Commonwealth in merchandise and specie during the last four years have averaged approximately £145,000,000. In the current year, 1929-30, they may reach £125,000,000, but nearly £25,000,000 will consist of bullion and specie exported under the powers given by the amendment of the Commonwealth Bank Act last December. Borrowing abroad, both public and private, gave Australia credits of at least £30,000,000 a year in recent years. This long-period borrowing has ceased for the present, but it is being supplanted in part by borrowing for short periods through the issue of Treasury bills in London and by overdrawing banking and Government accounts there. Like the export of gold, this is a means of temporary relief only.

Imports had not been appreciably reduced up to the end of March, but the effects of high exchange rates and restriction of credit in Australia and the prohibitions upon importation recently imposed by the Government have enforced a substantial reduction in the last three months of the year 1929-30. The premium on transferring funds to London and the high rates of interest in Australia also have the effect of keeping some funds in Australia which would normally be transferred. This is a further method of borrowing for short periods, for these funds will be transferred as soon as circumstances permit. To summarise the position for the present year, Australia will have to meet payments of at least £130,000,000 for imports and £30,000,000 for overseas interest. Her credits for this purpose consist of about £100,000,000 on account of exports of merchandise and £25,000,000 on account of gold exported, leaving a deficiency of at least £35,000,000 to be met by short-period borrowing in London or by the retention in Australia of funds that would normally be transferred.

How Exchange Rates Are Fixed.

But this is by no means the whole story. Apart from minor items in the balance of payments, such as the net expenditure of tourists abroad and the net cost of financial commissions earned by other countries, we have to face another lean year in which the fixed interest obligation must be paid, and the relief offered by exports of gold and short-period borrowing will be substantially reduced. That there will be a decrease in imports and an increase in exports, based on some recovery of wool prices and a better wheat harvest, may be expected. Assuming that we can borrow on short terms £10,000,000 in the next year, it will be necessary to have a surplus of exports over imports of £20,000,000 if the credits are to balance the debits in our international accounts.

The mechanism through which overseas payments are made is provided by the banks. The surplus of debits over credits in the international account reduces the London funds of the banks. In effect, when the bank sells a bill on London it is placing at the disposal of the purchaser so much ready money in London, or in some other overseas centre. If there is a shortage of London funds the bank charges more for the bill. On the other hand, it is ready to offer more to the Australian exporter for his bill on London, for this replenishes the London funds of the banks. The rate of exchange is thus a price that is affected by the supply of the London funds available for sale. Since it is a price, any upward movement in exchange rates tends to reduce the demand for such funds and to increase the supply. This is the advantage of a free exchange system as compared with the fixed system normally operating in Australia. It is true that the bill on London is now at a premium of 6¼ per cent. in Australia, and this means that £106/10/ in Australian currency is worth only £100 in British currency. But British wholesale prices are now less than 30 per cent. above their pre-war level and Australian prices are about 50 per cent. more. Hence the purchasing power of Australian currency has fallen relatively to that of British, and in a free exchange market this disparity in price levels normally causes exchange rates to move against Australia.

Restoring London Funds.

Australian banks, however, have always met an exchange difficulty such as the present by rationing advances, especially to importers. A study of the movements of banking funds shows that a decline in London funds normally coincides with an increase in the ratio of advances to deposits

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of Australian banks and a stringency of credit here. Unfortunately, the policy of rationing involves delay, and London balances are allowed to shrink excessively before drastic action to curtail imports is taken. If we had central control of exchanges and confidential knowledge of London balances, it would be possible to take action more rapidly and possibly more effectually. High rates of exchange have a threefold influence in correcting an adverse balance of payments. They act as a temporary but necessary impost upon imports, they offer a bounty to exports, and they encourage the retention of funds in Australia, or the transfer of funds from abroad, to take advantage of the exchange discount and high local interest rates. The identity of British and Australian monetary units and the close financial ties between Australia and London have discouraged variations in exchange rates, but in an open exchange system the rates would probably be higher than they are to-day. We have a deficiency of funds in London and a relatively high domestic price level—both conditions of high exchange rates.

The present rates must therefore be regarded as the minimum possible in the circumstances and there is a strong presumption in favour of raising them. But other measures have been taken to correct the position. The first is the temporary expedient of exporting surplus gold and short period borrowing, the second a drastic restriction of credit for imports, and the third an increase of import duties, prohibition of some imports, and rationing of others. All appear to be based upon the assumption that the deficiency of London funds is due to influences not connected with domestic conditions and that the situation can be remedied by measures similar to those adopted by some European countries during the post-war economic crisis. That these measures failed in Europe is a matter of historical interest now. Can they succeed in Australia?

Some Temporary Expedients.

With regard to the exportation of gold, the supplies available for export, apart from the normal annual production of about £2,000,000, will soon be exhausted. Similarly, short-term borrowing, unless it be stimulated by very adverse exchanges and high interest rates, is also incapable of much extension. The restriction of credit for imports will certainly have the effect of reducing the importation of goods that are not necessary as essential raw

materials for industry and domestic consumption. With very adverse exchange rates and such a restriction of credit a considerable decline in imports is inevitable, but with falling prices abroad and declining costs of production imported goods may be as cheap relatively as locally produced goods despite the exchange rates. To overcome this obstacle to a reduction of imports the method of prohibition or rationing of imports has been adopted. It is estimated that a decline in imports of approximately £5,500,000 will be achieved in this way. Naturally this will produce a temporary reduction in the demand for London funds, but the degree to which a permanent reduction will be attained depends largely upon the decline of prices and costs in Australia. It is in this respect that the temporary measures may not afford the permanent relief required. In the first place bank advances increased from £249,000,000 in the December quarter of 1927 to £292,000,000 in the same quarter of 1929, indicating that the banks have found it necessary to sustain Australian industry at present costs. Secondly, the Australian wholesale price level is still much higher compared with its pre-war level than the levels of prices abroad. Thirdly, the increases in the tariff made in November last and the surcharge of 50 per cent. upon the duties upon many commodities imposed subsequently will have the effect of keeping up the prices of protected goods, increasing the amount of such goods, and therefore adding to the burden of tariff costs that fall upon export industries.

Temporary measures to relieve a deficiency of London funds should be accompanied by readjustment of internal costs in order that the necessary increase of export production may take place. Such a readjustment of costs would involve a deflation of monetary incomes, a process that has now been initiated in some degree, and this in itself would involve a permanent reduction of expenditure upon imported goods. The decline in the Australian price level which would follow would reduce also the margin of profit received by the overseas exporter, while giving due encouragement to the Australian exporter. Unless these reactions follow, the deficiency in London funds can be met only temporarily by the expedients already adopted. There is, however, one possible course of action by which the Australian price level and Australian price costs may be sustained at their present level. This will be discussed to-morrow in the next article, in which an estimate of the loss of real as opposed to monetary income will be made and the economic effects of raising the exchange rate will be considered.

LOSS OF NATIONAL INCOME.

WHAT READJUSTMENT INVOLVES.

Some Essential Elements.

By PROFESSOR D. B. COPLAND.

II.

In estimating the ultimate loss of national income resulting from the prevailing depression, one must depend upon a good deal of intelligent guesswork. Dealing first with exports, we have no means of knowing what changes are likely to take place in export prices. The volume of export production will not be adversely affected unless "marginal" producers succumb to a disparity in the relation between Australian costs and export prices. Assuming, for the purposes of illustration, that in the process of economic readjustment any such disparity is eliminated, we may postulate the maintenance of the present volume of export production, and even its extension, with normal improvement in the technique of production. The first loss of income will then be equal to the fall in export values. Secondly, there is the uncertain factor of overseas borrowing. It would be erroneous to assume a continuance of the present unfavourable outlook for external loans, but how much will be borrowed in future can be a matter of conjecture only. Thirdly, there are the indirect repercussions of losses of income. These losses must be followed by a decline in the demand for both imported and Australian goods, and it is even more difficult to estimate the extent of the decline than to state the direct losses of income. Finally, there is great confusion between monetary and real income. It is misleading to make estimates of losses of monetary incomes without considering the reduction of real income that must be faced.

To focus attention upon the nature of the problem, assume that the decline in the prices of all exports, except wool, will be roughly proportional to the decline in general prices throughout the world. The loss of monetary income on all exports except wool may then be disregarded. For Australia there would be no loss of real income on this account. But the case of wool would certainly be different, for the fall in price in the last year is now much greater than the decline in general prices overseas. On the assumption that wool settles at a figure 30 per cent. less than its value in recent years, we should have an export of wool valued at roughly £38,500,000, compared with £55,000,000 in recent years. But the loss of real income is not the full amount of £16,500,000. If prices fell 10 per cent. wool exports might fall in value from £55,000,000 to £49,500,000 without a loss of real income. A fall to £38,500,000 would, therefore, involve a loss of £11,000,000. If we assume also that, say, £10,000,000 a year is raised by overseas loans, this would involve a reduction of borrowing of £17,000,000 at the lower price level. There would then be a loss of £28,000,000 in real income. This estimate is based on an assumption that exports other than wool fall in value only 10 per cent., an assumption not in accord with the present trend of the market. The value of these exports has been about £85,000,000 in recent years, and a decline of 10 per cent. in prices would place them at £76,500,000. A further fall of between 5 per cent. and 6 per cent. would place them at £72,500,000, involving a loss of real income of £4,000,000. The total loss of real income would then be £32,000,000, and total exports of Australian merchandise on these assumptions would be £111,000,000. But there are also indirect losses, because this direct decline in income reduces the demand for goods and services, just as a rise in income of the same amount will increase the demand for goods and services. Doubtless the rising tide of unemployment in recent months is a reflection of this decline in demand, and we have not yet reached the full extent of its repercussions.

Some Compensating Influences.

If we assume that the indirect losses of income are as great as the direct we have a total of £64,000,000. At the old price level national income was about £100 a head, or £640,000,000. A decline of 10 per cent. in prices would reduce this to £576,000,000, and the estimated loss of real income would then be 11 per cent. of total income. But there are compensations that would reduce this percentage. In the first place, a period of depression is one of reconstruction and increased efficiency in production. Management improves and a greater output by each person employed is attained. Secondly, if in the process of readjustment the costs, apart from monetary adjustments in the export industries, resulting from lower land values and wage rates, fall more than the decline in general prices, the income derived from these industries will not be reduced as much as I have supposed. This applies to wool, as well as to other exports, for my argument postulates a loss of income from wool to the full extent of the difference between the fall in general prices and the fall in wool prices.

On the assumption that the decline in costs in the export industries is 5 per cent. net, one may estimate the advantage accruing. We have wool exports estimated at £38,500,000 and other exports of £72,500,000, a total of £111,000,000. If a reduction of 5 per cent. in costs caused an increase of exports of nearly the same amount we have a gain of £5,000,000 to set off against the original loss estimated. But this is the direct gain and according to my argument there should be added an indirect gain of an equal sum, giving total compensation of £10,000,000. One has also to add something for increased efficiency in industries supplying non-export production and services. If the total income from these industries were £400,000,000 an improvement of efficiency of 1½ per cent. would add £6,000,000, giving a total compensation of £16,000,000, or one-fourth of the original estimated loss. Hence the ultimate loss of real income might be in the region of 8 per cent., and this would be reduced by later improvements in efficiency, which would probably be cumulative.

The Process of Deflation.

This comforting conclusion assumes that a process of economic readjustment has been successfully accomplished. What does this involve? We may consider two possibilities, the first of which might be regarded as financial heresy. Yet it has attractions. We have to face a loss of real income, and it is better to avoid mere monetary adjustments if such a course be practicable. At present Australian currency is at a discount of about 6½ per cent. upon sterling. If the discount were to rise to 10 per cent., so that £110 (Australian) might be exchanged for £100 (British), a deflation of the Australian price level in sympathy with overseas prices would not be necessary, a severe premium would be set upon imports, and a bounty would be granted to exports as compensation for the fall in export prices. This is what monetary authorities call preference for price stability as against exchange stability. France and some other European countries took this course after the war,

and thus avoided the painful readjustments involved in the process of deflation. But it must be emphasised that no inflation of the note issue or of credit should be permitted. There are three centres of disturbance: First, a decline in monetary wages and other incomes; secondly, a writing down of capital values; and, thirdly, acute deficiences in the public accounts, caused chiefly by the increase in the burden of the public debt, the fixed charges upon which for some time retain their high monetary value despite the fall in general prices. These disturbances are inevitable with falling prices, and they would be a serious temporary burden even without any loss of real income.

But there is also the unavoidable decline of real income to be met, and to this extent there must be a deflation of incomes and capital values, even if the exchange rate be altered as suggested, and no decline in prices take place in sympathy with falling prices abroad. There are thus two elements in the deflation process—first a readjustment of monetary incomes and values without any loss of real income or real capital values; and, secondly, the decline in incomes and capital values caused by the loss of real incomes. The first may be largely avoided by an adjustment of exchange rates. The second is unavoidable under any conditions. No reference is made in this discussion to the possibility of even higher exchange rates, and to a rise in Australian prices without a corresponding rise in incomes and wages, though this is a third course that might be taken.

We may now consider how the readjustment due to the loss of real income may proceed. At first the country experiences falling prices of stock exchange securities, declining profits in industry, and rising unemployment. This process has already proceeded far, and it involves a spreading of the burden over all classes, though inequitably among those classes. Certain reactions follow which carry the process further. To meet the distress caused by unemployment a tax upon incomes is necessary, and additional taxation must also be imposed to balance the public accounts. The latter necessity should not be disregarded because delay will only increase the burden, and if higher incomes bear the greater part of this additional burden of taxation, as well as experiencing a decline due to falling profits and capital values, an equitable basis will be provided upon which some readjustment of wages may be made. The elimination of the "Powers' three shillings" would involve a reduction of nearly 4 per cent. in wages, and this, together with the decline in wage rates hitherto in excess of the basic wage, would afford substantial relief. The basic wage would still be "the Harvester equivalent," but until unemployment was reduced to normal proportions real wages, allowing for unemployment, would have fallen. Special taxation to relieve unemployment by paying sustenance or providing relief works cannot increase the real demand for labour. It is merely a transfer of demand for work; the taxpayer has less, and the Government more. But it is a measure of relief, necessary in the circumstances, pending the absorption of the unemployed in industry as costs decline and the area of profitable production is increased.

BURDEN OF LOAN INTEREST.

DIFFICULTY OF TRANSFER.

Exchange Rates as Solution.

By PROFESSOR D. B. COPLAND.

III.

In recent years the interest on the overseas debt of Australia has been approximately equal to the annual borrowings abroad — about £30,000,000. Under the changed conditions of the immediate future borrowings will be much less and the value of exports also will decline. The interest burden will, however, remain at its former level, and one of the most difficult financial problems confronting Australia is the transfer of this sum annually to meet her interest payments. To collect the funds in Australia is by no means the most difficult problem. The Commonwealth Government now makes provision for this in the taxation it levies. While the process of economic readjustment will occasion some difficulty in maintaining the revenue necessary to cover interest payments and to meet ordinary expenses, this problem is simple compared with the task of transferring funds in London. In making payments in London the Government must have funds there upon which to draw.

These funds can be provided only by an excess of credits over debits in the balance of payments, exclusive of overseas interest. We may disregard the minor items and consider only loans abroad, exports, and imports. The first two are credits, the last a debit. In the long run an excess of the credits is required to meet the payments of interest.

One may pursue the argument developed in the last article. It was there assumed that borrowing would amount to £10,000,000 a year and exports of Australian merchandise to £111,000,000. To the exports must be added £3,000,000 worth of other produce (re-exports) and £2,000,000 for the normal annual production of gold. We thus have credits of £10,000,000 for loans and £116,000,000 for exports, a total of £126,000,000. From these credits we must pay for imports and for overseas interest. As the interest amounts to £30,000,000 imports will in these circumstances be only £96,000,000. If no loans were raised overseas the imports would have to fall to £86,000,000, unless an increase of export production could be attained. The magnitude of the transfer problem in the absence of overseas loans can best be realised by a comparison with Germany's transfer problem under the latest reparation settlement. Germany has to pay £100,000,000, about one-sixth of her exports, compared with less than one-fourth in Australia. But German exports consist of manufactured goods produced under the operation of decreasing costs as output increases. In Australia the principle of increasing cost is in operation, for extensions of production will normally take place on inferior or marginal lands. Moreover, the demand for German exports is probably more elastic than that for Australian; that is, a reduction of price will lead to a greater extension of demand for German exports than for Australian. But the German payment is divided into an unconditional annuity of £33,000,000 and a conditional annuity of £67,000,000, and provision is made for a postponement of the conditional annuity. Recent discussions indicate that economists are sceptical of Germany's capacity to transfer the full annuity of £100,000,000. Mr. H. D. Henderson, recently appointed one of the economists to the Economic Council for Great Britain, remarked:—"It is possible that Germany's capacity may not even be so much as the unconditional annuity." This is only £33,000,000, about 5 per cent. of total exports from Germany, and only 10/ a head, compared with 25 per cent. of exports and £4/10/ a head for Australia.

Dangers of the Tariff.

The Australian transfer problem is, however, the payment of interest upon a debt raised for productive purposes, and to this extent the country should be able to meet the obligation more readily than Germany. Australia has a further advantage over Germany. Her import trade does not consist to the same extent of the raw materials of domestic industry, and it is, therefore, more susceptible to reduction. Australia has been importing goods to the value of £140,000,000 during the last two years. Perhaps half of these goods are used in local production. Any reduction of this half would react upon Australian industry. Of the remainder, it is impossible to say what proportion may be classed as luxuries, or as non-essential commodities. It is significant, however, that in compiling a list of prohibitions imported goods to the value of only £4,250,000 a year were affected, while the 50 per cent. rationing will reduce imports by only £1,500,000 more. This is a total of less than £6,000,000. Other reductions of imports are expected as a result of the heavy increases in duties in the last two tariffs, but these reductions must not be looked upon as involving a net gain of an equivalent sum in the balance of payments. We may keep out imports by a tariff, but if the tariff increases the amount of protected production it also increases the burden of tariff costs that falls upon the export industries, and this reduces their capacity to increase production to meet the deficiency in the balance of payments. I assumed in the last article that the lowering of costs consequent on the loss of real income might amount to 5 per cent., and might account for an increase of exports of £5,000,000. Since, however, the added burden of tariff costs might offset some of the advantage gained from reduced costs, it would be unwise to count on the full increase of £5,000,000.

This is the danger of attempting to correct an unfavourable balance of payments and "create" employment by means of a higher tariff. It is in effect a measure of inflation, and it may be a hindrance to the progress of the fundamental economic readjustments required. We may keep out some imports in this way, but we also reduce our capacity to export. A much sounder procedure would be to raise exchange rates. This provides a kind of natural selection of imports, leaving those that are able to survive, and it has the

great merit of granting what is in effect a bounty to exporters as compensation for the disparity between high local costs and falling export prices.

The Loss of Taxation.

The extent to which additional tariff imposts may retard the increase of the export industries it is impossible to estimate. I have assumed an export trade of £116,000,000 after the adjustment of prices has been made, and a possible increase of £5,000,000. By the added burden of duties this increase will, however, be hindered. Any increase in export production can be attained only by improvements in technique or by lower costs, chiefly lower land values and wages. How far this may take place can be a matter of conjecture only, and it would be rash to assume an increase of exports over £120,000,000 a year on the average. With £10,000,000 in loans and £30,000,000 for interest to be paid, the value of imports would have to fall to £100,000,000, a decline of at least £40,000,000. This would involve a loss of Customs revenue of about £7,000,000, and the loss might be more if the reduction of imports occurred in luxuries and other non-essentials which now pay relatively high duties. This is about 23 per cent. of Customs revenue and more than 12 per cent. of total Commonwealth taxation. Some reductions of expenditure may be expected, but there will be a fall in other Commonwealth taxation also, and the net deficiency in the public accounts must be placed at not less than £6,000,000. This is how the change in the import trade will affect the public accounts, and since the States will find it necessary to impose additional direct taxation, chiefly on income, we must contemplate a considerable increase in taxation. The new taxation required will be less if the policy of raising the exchange rate be adopted. In this event, the decline in monetary incomes associated with a fall in domestic prices will not be necessary, and the fixed interest charges on the internal debt will not press so heavily upon the revenue from taxation.

It is necessary by way of conclusion to repeat the assumptions made in this discussion of the economic problem. I presuppose a fall of 30 per cent. in the value of wool and 15 per cent. in that of other exports. To avoid the disturbances of monetary deflation in Australia a raising of the exchange rate is suggested. It is recognised that this may be looked upon as a doubtful financial expedient, but it is nevertheless one that should be considered, and there is the recent example of France, Belgium, and Italy as a precedent. Thirdly, I assume heavy taxation to balance the Budget, to provide relief for unemployment, and to cover losses of Customs revenue. Next there is the reduction of incomes and wages due to the loss of real income. I have also assumed that lower costs of production with increased efficiency will follow, and that this will provide an avenue for the absorption of the unemployed, and an increase in production, especially export production. I contemplate borrowing at the rate of £10,000,000 a year and a decline in imports of £40,000,000. Finally, I have suggested that further indiscriminate increases in the tariff must be looked upon as a measure of inflation to be avoided. All these are doubtful assumptions, and a policy based upon them would meet with opposition. Yet the readjustments involved are unavoidable, and any delay in meeting the situation on the lines suggested might only increase the difficulties that must be faced in the end. There are doubtless serious obstacles, both economic and political, to the adoption of the policy suggested, but an analysis of the problem and the proposals for economic readjustment are offered in the hope that they may stimulate discussion of the fundamental issues involved

Wilson and Mackinnon, Printers, 365 Elizabeth Street, Melbourne, C.1.

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